Baillie Gifford™

China A Shares
Q1 investment update

April 2024

Investment manager Linda Lin and investment specialist Qian Zhang give an update on the China A Shares Strategy covering Q1 2024.

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Qian Zhang (QZ): Hello everyone, welcome to the video update for our China A Share Strategy. My name is Qian Zhang, I'm an investment specialist for the team, and I'm joined today by Linda Lin, the head of our China investment Team and portfolio manager for the China A Share Strategy.

Hi Linda.

Linda Lin (LL): Hi Qian.

QZ: Okay, so let's first dive into the key event that happened recently, which is China's annual parliamentary meeting. We call it the 'two sessions', which is perhaps the most important political and economic forum for the country. Many of our clients ask about what are the market implications from this. I'm keen to know what's your readings from this, Linda.

LL: I think that firstly, it's worth noting that for our China A Share Strategy, the focus is to find the best growth companies in the universe. As such, we're actually having a very engaged and active approach to research only a small number of companies, rather than reading the macro wind to timing the market. But saying that, I think the two sessions meetings actually provided some very valuable watching points for current economy situation in China, and also the future policy direction that actually is very important. So three observations that I want to share.

Firstly, I think the current announced stimulus package is moderate. I think the government is still taking the middle step for that. This is lower than the market expectation. I think what the market is looking for is to rebuild the strong confidence that Chinese government can handle the ongoing challenges in the economy situation.

I think secondly, the most positive one, the government actually emphasised they will continue to support the private companies. I think in some of our portfolios, the founders are actually looking for a stable and transparent regulation environment. I think that's going to be the case now. So that will remove some of the concerns, which is called regulation risk premium, over some of our holdings. I think certainly, which I think is a continuation of what the government has been trying to deliver the message for the last few years, on the new drivers of Chinese economy. I think they mentioned upgrading of manufacturing, and also trying to emphasise the importance of technology, digitalization, and education. I'm sure there are a number of companies in our portfolio that are going to benefit from the policy. Overall, I think the outcomes are under our expectation, but are not inspiring for the market. I think that the market sentiment generally turned a bit more positive from February. But I feel any temptation to bet on the momentum direction of what's macroeconomic direction will go are questionable. So stock picking actually remains key for us.

QZ: Yes, thank you for that.

I think the key question from here, especially for us as growth investors and stock pickers, is that how do you see individual growth opportunities under such a backdrop, where the macroeconomy is slowing? There are multiple headwinds, and also there's no big stimulus coming in. Why can companies still grow under such a scenario?

LL: That's actually a very good question. I think the market, especially the Western media, they always focus on the rate of growth in China. But actually, the size of growth is more important to me when we're looking at some of the innovative companies who are actually driving or benefiting from long-term secular trends. China GDP now is two times of Japan, six times of India, and also six times of all those Asian countries combined. Also, it's bigger than the 27 countries in Europe putting together. So when we're talking about this size of domestic economy, and also dense of talent, supply chain advantage, and also the capital, these provide a very exciting experimental land for the innovative company in China to grow.

We actually went back to China in January when the market sentiment was extremely low. On one side all talked about the property market, the geopolitical risk, and also regulation headwinds. But on the other side, we actually identify a group of very exciting growth companies at operational level. I can show you a few examples. One private company called Little Red Book, that's one of the leading social e-commerce players in China. They actually have grown their revenue and profits multiple times in the last two years. And also a portfolio company, Sungrow, which is a solar converter leader in the world space. They actually announced the profit can grow about 150 per cent. Proya, which is a domestic cosmetic brand. Under this very weak economy environment and competitive market, we can still see these companies keep taking market share. They have done very well in the recent Women's day's sale across all the e-commerce platforms in China. And the last one is interesting, Anker, which is one of the most popular consumer electric brands on Amazon, they generate most of their income outside of China and in the last three quarters, this company has grown their revenue by more than 30 per cent. So I can have a long list to go on and on. But generally speaking, looking from the bottom-up stock research perspective, I still remain confident there are plenty of actual growth Chinese companies which can be found from the active research process. But the strong fundamentals for those individual companies are totally forgotten by the markets when the market is super focused on where the property market will go and also what the geopolitical risk will do. So I think that gives us a very exciting point as a stock picker. And hopefully we can keep hunting those names for our clients.

QZ: Thank you for that. I think most of our clients would actually agree that there are still a lot of actual growth at a company level in China. But the key question going forward from here is, will the market eventually recognise them and reward them with decent share price returns? Because the macro-overhang has been lasting for longer than people would have expected. What's your view here?

LL: Yeah, I still believe yes. But the key for us is to try to find those long-term winners early and hold them for long and finally let those big winners to win. One challenge, also I think it's one consistent challenge when we're looking at China is a very short-term focus of the markets and also the market peers. One key advantage that we can bring to investing is a real long-term and patient approach that actually allowed us to ignore the short-term price fluctuation and focusing on finding those best names which can drive the long-term and secular trends for China. I think that really matters for the long-term return. So CATL, actually the leading battery company in the world can be a very good example for this. We firstly invested in this company in 2019, and since then this company has grown the revenue and profits by almost 10 times. I think the share price, it has dropped nearly half since the peak in December 2021, but this company still delivered 2.5 times return for our clients. So we trimmed it when the market multiple was high. But recently after the de-rating, we reviewed the investment case and we found the valuation gets very attractive for its upside and then we took the opportunity to add. I think it is true as you said Qian, the macro issue which has dominated the market sentiment much longer than we have expected. Our strategy underperformed during the recent period. We explained in the last video that according to our data, the Chinese state-owned enterprise outperformed non-SOE significantly in 2023 when the market was in a weak shape. That also is not supportive to our growth investment. However, we actually see little reason to change in our investment philosophy and process because we don't really want to sacrifice our return requirements and also the governance standards to chase the short-term returns. Where our focus remains still on finding the best growth companies in that universe who can deliver the long-term sustainable growth.

QZ: Thank you for that. You mentioned the details about CATL. Are there any other tradings that you have done recently in the portfolio that are worth highlighting?

LL: Yeah, I think generally speaking the turnover of the portfolio remains relatively low according to our investment philosophy and also that shows our confidence in the current shape of the portfolio. But there are lots of research going on and also a lot of debates about the names in the portfolio. I think when we are looking at the current portfolio, we are not actually shying away from selling some of the growth companies who are not meeting our high growth hurdle anymore. Two examples, one is Haitian Soy Sauce. It is a very high-quality company with endurance but according to current valuation and upside, we don't believe it actually can take a space in this very highly concentrated growth portfolio. Another one is Ping An Insurance. We are bearing in mind after the weakness of the current share price, the valuation looks very attractive, but our upside case of the Chinese private insurers have fallen down. So we took some position out from the portfolio and recycled the capital to add to those companies who actually have shown us the long-term resilience on their operational level. CATL and Anker which I have mentioned before. And also we added to Central Testing which is a third-party service provider for the testing services in different industries in China. And we also have a lot of new names going on for the second round research or sitting on the watch list for us to having a better entry point. But looking at the shape of the portfolio, I think we do have notable exposure to the several growth areas, including the rise of domestic brands, green transition, manufacturing upgrades and also innovative healthcare in the future. And I still strongly believe those areas are going to benefit from the policy tailwind. Last but not the least, those companies with this type of quality of fundamentals are offering a big discount now, which I personally haven't seen in the market for many years.

QZ: I see.

Thank you, Linda. If I try to summarise our discussion, I'd probably say there are three main points. Number one is the macro situation appears to be sort of a status quo after the two sessions. Number two, even with that backdrop that doesn't derail the actual, excellent growth from a lot of the individual companies that you see on the ground, who are actually driving or benefiting from the longer-term secular themes. Last but not least, our portfolio is well positioned for a gradual recovery of the economy and consumer confidence, as well as a return of market focus on the company fundamentals.

Thank you for joining us all. We hope this was a helpful update and we'll see you next quarter.

LL: Thank you.

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China A Shares

Annual past performance to 31 March each year (net%)

	2020	2021	2022	2023	2024
China A Shares Composite*	10.0	80.3	-13.2	-9.8	-34.9
MSCI China A Onshore Index	-6.5	49.9	-7.9	-9.3	-17.1

Annualised returns to 31 March 2024 (net%)

	1 year	5 years	10 years	Since inception
China A Shares Composite*	-34.9	0.2	N/A	1.4
MSCI China A Onshore Index	-17.1	-0.6	N/A	0.6

*Inception date: 28 February 2019.
Source: Baillie Gifford & Co and MSCI. USD. Returns have been calculated by reducing the gross return by the highest annual management fee for the composite.

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